INVESTMENT
COMPANY
INSTITUTE

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November 18, 2010

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Re: Rulemaking Implementing Certain Orderly Liquidation Authority Provisions

Dear Mr. Feldman:

The Investment Company Institute[1] appreciates the opportunity to comment on the FDIC's proposed rule implementing certain provisions of its authority to resolve covered financial companies under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[2] As investors of over $5 trillion in the bond and money markets,[3] Institute members have a strong interest in ensuring that the liquidation of covered financial companies[4] minimizes risk to the financial system, maximizes the value and minimizes the losses from the liquidated company, and treats creditors fairly in doing so.

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[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $12.05 trillion and serve over 90 million shareholders.

[2] *Notice of Proposed Rulemaking Implementing Certain Orderly Liquidation Authority Provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act*, 75 Fed. Reg. 64170 (Oct. 19, 2010) ("Notice").

[3] 2010 Investment Company Fact Book at 126, available at www.icifactbook.org.

[4] Under the Dodd-Frank Act, covered financial companies are non-bank financial companies that have been designated by the Secretary of the Treasury, after consultation with the President, based on certain statutory findings. These findings include that: the company is "in default or in danger of default"; its failure and resolution under otherwise applicable law would have serious adverse effects on U.S. financial stability; and, there is no viable private sector alternative to prevent the company's default.

Adherence to two overarching principles – *clarity* and *restraint* – will help achieve these goals. To that end, we applaud the FDIC for attempting to clearly define and circumscribe the situations in which similarly situated creditors may be treated differently during the liquidation of a covered financial company. Institute members previously expressed concern that the broad authority granted by the Dodd-Frank Act to the FDIC,[5] and the uncertainty about how such authority would be used, could create market distortions and other unintended consequences.[6] We believe the proposal to exclude long-term bondholders and certain other creditors from the categories of creditors who may receive additional payments, and require the FDIC board to make the statutory findings before any such payments are made, substantially addresses these concerns.

In keeping with the principles of clarity and restraint, we offer several additional comments on the proposed rule. Most notably, we recommend that the FDIC reconsider its proposal to value U.S. Treasury and agency securities used as collateral at par value. While we recognize the appeal of providing incentives for using higher quality collateral in repurchase agreements,[7] we believe this proposal could actually create perverse incentives and other unintended consequences. We also request further clarification of the scope and mechanics of proposed §380.2(c), and the import of §380.4 for excluded claims. Uncertainty among market participants as to how the proposed rules will be implemented could cause unpredictable market behavior. These comments are discussed further below.

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[5] Section 210(b)(4) of the Dodd-Frank Act permits the FDIC to treat similarly situated claimants of a covered financial company differently if the FDIC determines that doing so is necessary to: i) maximize the value of the company's assets; ii) initiate and continue operations essential to implementation of the receivership or any bridge financial company; iii) maximize the present value return from the sale or other disposition of the assets of the covered financial company; or iv) to minimize the amount of any loss realized upon the sale or other disposition of the assets of the covered financial company. *See also* Sections 210(d)(4) and 210(h)(5)(e).

[6] *See, e.g.,* Letters from George U. Sauter, Chief Investment Officer, The Vanguard Group, and Lyn Perlmuth, Director, Fixed Income Forum, to the Honorable Christopher J. Dodd, Chairman, and The Honorable Richard C. Shelby, Ranking Member, U.S. Senate Committee on Banking, Housing & Urban Affairs, dated April 22, 2010 and April 29, 2010 (expressing concern about the market risks that could be created by allowing the FDIC to designate certain bondholders to receive more than other holders of identical securities). *See also* Letter from Paul Schott Stevens, President and CEO, Investment Company Institute, to The Honorable Barney Frank, Chairman, The Honorable Spencer Bachus, Ranking Minority Member, Committee on Financial Services, U.S. House of Representatives, and The Honorable Christopher J. Dodd, Chairman, and The Honorable Richard C. Shelby, Ranking Minority Member, U.S. Senate Committee on Banking, Housing & Urban Affairs, dated June 3, 2010.

[7] *See* Press Release: FDIC Board Issues Proposed Rule on Claims Process Under New Resolution Authority, October 12, 2010 ("Secured obligations collateralized with US government securities will be valued at par. This provision should create additional incentives for market participants to use highly liquid and easy to value collateral such as US government obligations to collateralize short term debt.").

Valuation of Certain Collateral in Secured Transactions at Par (§380.2(c))

As the Notice explains, to the extent a creditor of a covered financial company participating in short-term, secured transactions such as repurchase agreements is under-secured, the unsecured portion of the claim will be paid as a general creditor claim. As a result, proper valuation of the collateral underlying the secured portion of the claim is extremely important. Under proposed §380.2(c), collateral consisting of U.S. Treasury securities or other securities offered or guaranteed by the United States or any agency thereof ("Government Securities") would be valued at par.[8] We have concerns with the valuation of any type of collateral at anything other than its fair market value.

Most importantly, paying more than fair market value for certain types of collateral and par value for others could create perverse incentives. For example, in a market environment in which Government Securities are trading at a discount – an environment we could see in the near future if interest rates rise – market participants could have an incentive to under-collateralize positions using these securities (based on their fair market value), knowing that in the event of default the creditor will be paid at par. The proposal could also create incentives to use lower quality Government Securities than creditors might otherwise accept. For example, mortgage-backed securities issued by government-sponsored enterprises would appear to be Government Securities.[9] This market includes a number of more esoteric instruments, such as stripped mortgage-backed securities. A creditor who may otherwise have demanded more stable collateral may accept such instruments based on the guarantee that he will receive par in the event his counterparty is placed in receivership.

Additionally, unless the FDIC intends to fund the difference when these securities are trading at a discount, valuing such collateral at par will be at the expense of other claimants, including unsecured creditors and shareholders. If the receivership pays out more than the fair market value of the collateral securities in exchange for these instruments, fewer assets will remain to resolve other

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[8] The literal reading of this provision provides that it is the "proven claim," rather than the Government Securities, that is valued at par. We note that this is inconsistent with the rest of the proposed rule, as well as Section 210(a)(3)(D) of Title II, which address the valuation of *collateral* to determine the amount of a secured claim, not the valuation of the claim itself. In addition, the literal reading would lead to clearly unintended results; for example, a $100 claim secured by $50 of Government Securities would be valued as a $100 secured claim. Accordingly, we do not believe that the literal reading could be the intended meaning, and we recommend that the FDIC clarify the rule text.

[9] This is consistent with interpretations by SEC staff. *See, e.g.,* Federal National Mortgage Association, SEC No-Action Letter, July 12, 2002, available at http://www.sec.gov/divisions/corpfin/cf-noaction/fanniemae071202.htm (on behalf of certain Divisions of the U.S. Securities and Exchange Commission, concurring with the view that securities issued or guaranteed by Fannie Mae are government securities for the purposes of the Investment Company Act of 1940 and certain rules under the Securities Exchange Act of 1934). If the FDIC chooses to proceed with valuing government securities at par, we recommend that the rule clearly define which securities are intended to receive this preferential treatment.

claims. We do not believe it is appropriate to create incentives for certain types of secured transactions at the expense of unsecured claimants.

Finally, we believe the proposal ignores the possibility that Government Securities could trade at a premium to par. If this premium were considered in establishing collateral, a creditor in a fully collateralized transaction could be treated as under-secured if the collateral were ultimately valued at par. This result seems contrary to the FDIC's goal of encouraging market participants to use such securities as collateral. This concern could potentially be resolved by clarifying that such collateral shall be valued at either its fair market value or par, whichever is greater. As noted above, however, in the event that the par value is greater than the fair market value, the extra payment to creditors holding this collateral would likely be at the expense of other claimants.

To avoid creating perverse incentives and other potential unintended consequences, we recommend that the FDIC not attempt to create incentives for creditors to demand certain types of collateral. Setting forth a clear process for resolving secured claims, as the proposed rule attempts to do, should help secured creditors behave more rationally. Attempting to change market drivers further, on the other hand, may result in unintended consequences.

Recommended Clarifications

As noted above, we believe that clarity and certainty as to rule scope, interpretation and implementation are critical for market participants in responding rationally and efficiently to new rules. As frequent participants in the repurchase agreement market, as well as parties to over-the-counter derivatives transactions, Institute members are particularly interested in the scope and operation of §380.2(c), irrespective of the treatment of Government Securities as discussed above. Additionally, the narrow definition of "contingent obligation" in §380.4 leaves an open question as to the treatment of obligations excluded from the definition, which obligations may be a feature of certain types of money market instruments.

<u>§380.2(c)</u>

The scope of §380.2(c), as described in the Notice and rule text, is not entirely clear. We believe the section is not intended to apply to contracts that are transferred to a bridge company. Further, we believe that, in providing guidance on the determination of collateral values, the FDIC did not intend to affect the rights of a counterparty to a qualified financial contract to sell or retain its collateral in accordance with its agreement to the extent permitted under Section 210(c)(8)(A) of the

Dodd-Frank Act.[10] We would have serious concerns if the scope of this section was intended to be broader, in which case we believe it could impinge on the rights of parties in the repurchase agreement market.[11] We recommend that the Notice clarify that the section only applies if a contract is not transferred to a bridge entity, and that the section is not intended to affect those of a counterparty's contractual rights that are protected by Section 210(c)(8)(A).

Further, it is not clear whether the section is intended to be limited to repurchase agreements,[12] or whether it captures collateralized over-the-counter derivatives contracts and other financial contracts that may have a "security interest or security entitlement." Application to derivatives contracts may impact parties' rights under their ISDA agreements. We request clarification on the application of the section beyond repurchase agreements.

Institute members and market participants generally would also benefit from further clarification regarding the mechanics of §380.2(c). For example, the section or the accompanying Notice should set forth how, and as of what date, the fair market value of collateral will be determined. In addition, it should clarify how this determination will affect the treatment of claims under qualified financial contracts where the collateral is either liquidated by the creditor counterparty, or retained and valued according to the terms of the financial contract, at different value than the one determined under the proposed rule. Finally, if the FDIC goes forward with differential treatment of certain government obligations, it should establish with more specificity which instruments will be captured.[13]

<u>§380.4</u>

The definition of "contingent obligation," and therefore the application of §380.4, excludes obligations that are triggered by an event that 1) is under the control of the covered financial company or the party to whom the obligation is owed and 2) has not occurred yet. The status of these excluded

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[10] Among other things, this section affirms that a counterparty shall not be prohibited or stayed from exercising termination, liquidation, and acceleration rights under a qualified financial contract that arise on or after the date of the appointment of a receiver.

[11] These parties expect that, after the one-day stay, they will either be permitted to foreclose on collateral, or their contracts will be transferred to a bridge company, at which point the contracts may be closed out at their expiration. Rules that would delay or impose uncertainty into this resolution process could reduce the attractiveness of repurchase agreements.

[12] The Notice explains that one major driver of the 2008 financial crisis, and therefore impetus for the proposed rule, was "an overreliance by many market participants on funding through short-term, secured transactions in the repurchase agreement market using volatile, illiquid collateral." Notice at 11.

[13] *See supra* note 9 and accompanying text.

obligations is not clear. This is an important question for funds that invest in instruments, such as tender option bonds and variable rate demand obligations, that are backed by a direct-pay letter of credit or standby purchase agreement issued by a covered financial company.[14] We assume that, by excluding such obligations from the definition of "contingent obligation," the FDIC intends for such obligations to be deemed fixed at the time of the appointment of the receiver and allowed to the extent that the fund ultimately incurs a loss on the underlying security. We support this approach, and request clarification to that effect.[15]

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ICI appreciates the FDIC's attention to our comments. If you have any questions, please contact me at 202/326-5815 or Brian Reid, ICI's Chief Economist, at 202/326-5917.

Sincerely,

/s/ Karrie McMillan

Karrie McMillan
General Counsel

CC: Robert E. Plaze, Associate Director
Division of Investment Management
U.S. Securities and Exchange Commission

Matthew Eichner, Deputy Associate Director
Patricia White, Senior Associate Director
Federal Reserve Board

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[14] Under the terms of these letters of credit and standby purchase agreements, a fund or other investor may, at its own election, "put" the instruments to the provider. Thus, the trigger for the obligation is under the control of the party to whom the obligation is owed.

[15] If, on the other hand, the intent was that such claims would be contingent but would not be provable pursuant to §380.4, we request further clarification of the provability of such claims. We have been advised that such claims would be provable in a liquidation under Chapter 7 of the Bankruptcy Code, and we believe they should receive the same treatment in the orderly liquidation of a covered financial company.